

Internal Revenue Service

memorandum

CC:TL-N-3285-90

TS/Rosenberg

date: APR 13 1990

to: District Counsel, San Francisco W:SF  
Attn: Lori M. Honjiyo

from: Assistant Chief Counsel (Tax Litigation) CC:TL

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subject: [REDACTED] v. Commissioner - Tax Motivated Transactions

TL-N-3285-90

CC:TL:TS

Rosenberg

Wilson

I.R.C. § 6621(c)

This memorandum is in response to your request for tax litigation advice dated February 5, 1990.

ISSUE

Whether the taxpayer's concession of a deficiency in his amended petition on the grounds that: (1) the allowance of losses in the year claimed distorts the taxpayer's income pursuant to I.R.C. § 446(b); (2) the claimed losses are disallowed pursuant to I.R.C. § 1091; and (3) the taxpayer has not provided adequate records to substantiate the claimed losses, precludes the respondent from asserting I.R.C. § 6621(c) additional interest.

CONCLUSION

Petitioner's concession of the deficiency on the ground that the allowance of losses in the year claimed distorts his income pursuant to I.R.C. § 446(b), gives rise to a tax motivated transaction under I.R.C. § 6621(c)(3)(A)(iv) and Temp. Treas. Reg. § 301.6621-2T A-3(9). Thus, the concession of the deficiency on this ground will support the imposition of additional interest under section 6621(c). Further, if respondent is able to introduce evidence establishing that the transactions were straddles, section 6621(c) additional interest could also be imposed on the basis of section 6621(c)(3)(A)(iii).

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FACTS

The petitioner, [REDACTED], was an investor in [REDACTED] during the [REDACTED] taxable year. The petitioner deducted ordinary losses from the [REDACTED] transactions on his [REDACTED] individual federal income tax return in the amount of \$[REDACTED]. For the year at issue, petitioner computed taxable income using the cash receipts and disbursements method of accounting. All of the losses were subsequently disallowed by the Service in a statutory notice of deficiency which was mailed to the petitioner on [REDACTED]. The statutory notice also asserted additional interest under I.R.C. § 6621(c) and additions to tax under I.R.C. § 6653(a). On [REDACTED], the petitioner timely filed a petition with the Tax Court. On [REDACTED], the petitioner mailed to the Tax Court a Motion for Leave to Amend Petition and Proposed Amendment, and the First Amendment to Petition.

In the First Amendment to Petition, the petitioner concedes the adjustments for [REDACTED] relating to the [REDACTED] transaction on three grounds: (1) that the allowance of losses in the year claimed distorts the taxpayer's income pursuant to I.R.C. § 446(b); (2) that the claimed losses are disallowed pursuant to I.R.C. § 1091 and (3) that the petitioner has not provided adequate records to substantiate the claimed [REDACTED] losses.

Petitioner's concession of the deficiency is being made prior to trial. Petitioner's reason for making these concessions is to avoid the imposition of section 6621(c) additional interest based upon Todd v. Commissioner, 89 T.C. 912 (1987), aff'd 862 F.2d 540 (5th Cir. 1988) and McCrary v. Commissioner, 92 T.C. 827 (1989). In Todd and McCrary, the Tax Court held that the petitioner is not liable for additions to tax under sections 6659 and 6621(c) where the grounds for the disallowance of the deficiency would not involve a finding of the prohibited conduct necessary to invoke the penalty. Petitioner would argue that under the rationale of Todd and McCrary, the grounds upon which they are conceding the deficiency do not support the imposition of section 6621(c) additional interest. An appeal of the [REDACTED] case would be to the Fifth Circuit.

District Counsel recommends that the Service reject petitioner's concessions in order to pursue the section 6621(c) penalty. Alternatively, District Counsel points out that petitioner has conceded the deficiency based on two grounds which support the imposition of section 6621(c). First, the petitioner's concession that the allowance of losses in [REDACTED] distorts his income pursuant to I.R.C. § 446(b) meets the definition of a tax motivated transaction under section 6621(c)(3)(A)(iv) and Temp. Treas. Reg. § 301.6621-2T A-3(3). Temp. Treas. Reg. § 301.6621-2T A-3(3) provides that certain interest deductions disallowed due

to overstatement of the true cost of indebtedness is a use of an accounting method which may result in a substantial distortion of income and is thus a tax motivated transaction.

Second, District Counsel asserts that petitioner's concession that the claimed losses are disallowed pursuant to I.R.C. § 1091 is a basis for imposing section 6621(c) because the underlying transaction involved a straddle. Any straddle as defined in section 1902(c) (without regard to subsections (d) and (e) of section 1092) is a tax motivated transaction for purposes of imposing section 6621(c) additional interest. I.R.C. § 6621(c)(3)(A)(iii).

### DISCUSSION

I.R.C. § 6621(c) provides for an interest rate of 120% of the statutory rate on substantial underpayments that exceed \$1,000, and are attributable to tax motivated transactions, as defined in section 6621(c)(3). I.R.C. § 6621(c)(3) defines the term "tax motivated transaction" to include:

- (iii) any straddle (as defined in section 1092(c) without regard to subsections (d) and (e) of section 1092),
- (iv) any use of an accounting method specified in regulations prescribed by the Secretary as a use which may result in a substantial distortion of income for any period . . .

Temp. Treas. Reg. § 301.6621-2T-A3 sets forth the accounting methods that may result in a substantial distortion of income and, thus, give rise to a tax motivated transaction. These accounting methods include:

(3) Any interest deduction disallowed for any period because the amount of the claimed deduction was computed using a method resulting in an amount of interest for a period that exceeds the true cost of the indebtedness for the period computed by applying the effective rate of interest on the loan to the unpaid balance of the loan for that period (i.e., the economic accrual of interest for the period), provided the interest is not accrued with respect to indebtedness incurred in connection with (i) the purchase, refinancing, or improvement of the principal residence of the taxpayer, or (ii) the purchase of consumer goods by the taxpayer (see Rev. Rul. 83-84, 1983-1 C.B. 97, and sections 163(e), 446(b), and 483); . . .

(9) In the case of a taxpayer who computes taxable income using the cash receipts and disbursements method of accounting, any deduction disallowed for any period because (i) the expenditure resulting in the deduction was a deposit rather than a payment, (ii) the expenditure was prepaid for

tax avoidance purposes and not for a business purpose, or (iii) the deduction resulted in a material distortion of income (see, e.g., Rev. Rul. 79-229, 1979-2 C.B. 210).

The Tax Court has held that section 6621(c) interest may not apply where the underlying deficiency is sustained by the court on a basis which is not defined as a tax motivated transaction even though the respondent alleged an alternative basis which is defined as a tax motivated transaction. See Irom v. Commissioner, T.C. Memo 1988-211, vacated in part and remanded, 866 F.2d 545 (2d Cir. 1989); McCrary v. Commissioner, 92 T.C. 827 (1989). The basis for the court's interpretation is that in such circumstances the underpayment is not attributable to a tax motivated transaction as required by section 6621(c). However, section 6621(c) will apply when a category of tax motivated transaction is an integral part of, or inseparable from, the ground for disallowance of an item of deduction or credit. See McCrary, supra; Wilson v. Commissioner, T.C. Memo. 1989-266. The court's interpretation of the "attributable to" language of section 6621(c) is analogous to its interpretation of similar language in section 6659. See Todd v. Commissioner, 89 T.C. 912 (1987), aff'd, 862 F.2d 540 (5th Cir. 1988); Gainer v. Commissioner, T.C. Memo. 1988-416, aff'd, No. 88-7502 (9th Cir. January 4, 1990).

The Tax Court has also recently addressed the question of whether section 6621(c) will apply when the taxpayer concedes a ground for the disallowance of deductions and credits in order to avoid the imposition of section 6621(c) additional interest. Where the taxpayer concedes a ground for the disallowance of deductions and credits that does not involve a finding of a tax motivated transaction, prior to trial, the Tax Court has accepted this concession and refused to apply section 6621(c) additional interest. McCrary, supra.

In McCrary, the petitioners invested in a master recording leasing program. These master tapes were purchased at an inflated price and an investment credit based on that inflated price was passed through to petitioners. Petitioners claimed the investment credit, rental expenses, and distribution fees resulting from their investment. In the statutory notice of deficiency, the Service listed multiple grounds for its disallowance of the investment credit, including: (1) the transactions were not bona fide, arms length transactions at fair market value; (2) the transactions lacked economic substance; (3) the transactions were not incurred in a trade or business or entered into for profit; (4) the basis of the asset was zero; (5) the asset was not placed in service; and (6) the asset was a license or nonexclusive right rather than a lease. Prior to trial, in order to avoid the application of section 6621(c), petitioners unilaterally conceded that the investment credit should be disallowed because the

purported transaction involved a license rather than a lease. The court accepted this concession. Although the Service had disallowed the investment credit on bases which would invoke section 6621(c), the grounds for petitioners' concession would not.

Following Todd, the court in McCrary found that section 6621(c) would not apply to that portion of the underpayment attributable to the concession. The court recognized that the investment credit would have also been disallowed under the alternative theories of sham or lack of profit objective. Either of these two theories would have given rise to the application of section 6621(c). However, the court refused to make such alternative findings.

We recommend against opposing the proposed concession of the deficiency by the petitioner. Disposing of issues by concession or stipulation is encouraged by Tax Court rules, see T.C. Rule, 91 and avoids unnecessary use of resources by the court, the Service and taxpayers. Although we think the rationale of Todd and McCrary is incorrect, the Tax Court has embraced the holding of those cases and there is no legal rationale for opposing the concession.

We agree with your conclusion that the taxpayer has conceded the deficiency on grounds which support the imposition of I.R.C. § 6621(c). Thus, the Todd and McCrary cases are distinguishable. However, our analysis of the categories of tax motivated transactions upon which section 6621(c) additional interest should be imposed differs in certain respects from the approach suggested in your memorandum.

We agree with your conclusion that petitioner's concession of the deficiency on the ground that the allowance of losses in the year claimed distorts the taxpayer's income pursuant to I.R.C. § 446(b) supports the imposition of section 6621(c) additional interest. Section 6621(c)(3)(A)(iv) includes in the definition of a tax motivated transaction, "any use of any accounting method specified in regulations prescribed by the Secretary as a use which may result in a substantial distortion of income for any period." In your memorandum requesting this advice, you question whether Temp. Treas. Reg. § 301.6621-2T A-3(3) may be used to support the imposition of section 6621(c). You note that this paragraph includes a reference to section 446(b). However, as you point out, Temp. Treas. Reg. § 301.6621-2T A-3(3) concerns a situation where interest deductions are disallowed due to the overstatement of the true cost of indebtedness. Since the disallowance of interest deductions is not an issue in this case, we should not rely on this section of the regulations to support the imposition of section 6621(c) additional interest. Rather, we

recommend that you rely on Temp. Treas. Reg. § 301.6621-2T A-3(9) as support for your position. Temp. Treas. Reg. § 301.6621-2T A-3(9) provides:

In the case of a taxpayer who computes taxable income using the cash receipts and disbursements method of accounting, any deduction disallowed for any period because (i) the expenditure resulting in the deduction was a deposit rather than a payment, (ii) the expenditure was prepaid for tax avoidance purposes and not for a business purpose, or (iii) the deduction resulted in a material distortion of income (see, e.g., Rev. Rul. 79-229, 1979-2 C.B. 210). (Emphasis supplied)

Petitioner was a cash method taxpayer for the year in question. The petitioner has conceded that the allowance of losses in the amount of \$ [REDACTED] in the year claimed distorts his income pursuant to section 446(b). The deduction of these losses by the petitioner resulted in a material distortion of income under Temp. Treas. Reg. § 301.6621-2T A-2(9), and constituted a tax-motivated transaction under section 6621(c)(3)(A)(iv).

We point out that Temp. Treas. Reg. § 301.6621-2T A-3(9) includes a reference to Rev. Rul. 79-229, 1979-2 C.B. 210. This ruling held that a cash-method taxpayer engaged in the business of raising or feeding livestock may deduct in the year of payment amounts paid for livestock feed to be consumed in a subsequent year provided: (1) the expenditure is for the purchase of feed rather than a deposit; (2) the prepayment is made for a business purpose and not for tax avoidance; and (3) the deduction will not result in a material distortion of income. While the ruling requires that all three conditions must be met in order to claim a deduction, the regulation states that if any one of the three conditions is not met, then the transaction is tax motivated. Temp. Treas. Reg. § 301.6621-2T A-3(9) uses the word "or" between parts (ii) and (iii) of the regulation, rather than "and", which is used in the ruling. Additionally, the reference to Rev. Rul. 79-229 in the regulations is only for informational purposes. It serves as an example of how each of the three conditions has been interpreted. It should not be interpreted to mean that the ruling is incorporated into the regulations.

Additionally, you state in your memorandum that petitioner's concession of the deficiency on the ground that the claimed losses are disallowed pursuant to section 1091 will also support the imposition of section 6621(c). The basis for your position is that the deficiency conceded pursuant to I.R.C. § 1091 involved transactions that were tax straddles as defined in section 1092. The fact that the underlying transactions involved tax straddles

would, therefore, result in the transactions being tax motivated pursuant to section 6621(c)(3)(A)(iii). However, in order to be successful under this position, respondent would have to put on evidence that the transactions conceded pursuant to section 1091 did in fact involve tax straddles since section 1091 does not specifically nor necessarily involve straddle transactions. Under the rationale of Todd and McCrary, the Tax Court does not need to go any further than to accept the petitioner's concession in order to find a deficiency. Thus, it is unlikely the court will allow evidence to be introduced to determine whether petitioner's concession of the deficiency is capable of being attributed to a tax motivated transaction, when the ground on which the deficiency has been conceded is not directly attributable to a tax motivated transaction as defined in section 6621(c)(3).

However, you note in your request for tax litigation advice that respondent may be able to introduce evidence establishing that the transactions were straddles in connection with defending the negligence penalty. You correctly noted that the negligence penalty does not lend itself to being side stepped by selective concessions by the taxpayer. We agree that Gantner v. Commissioner, 91 T.C. 713 (1988) lends support for the position that section 6621(c) may be imposed as long as the court makes a finding that the loss was with respect to a straddle transaction. Given the fact that you may be able to introduce evidence establishing that straddle transactions occurred, we recommend that you also assert the position that section 6621(c) additional interest can be imposed because the transactions involved a straddle as defined in section 1092(c).

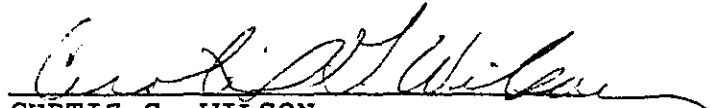
In conclusion, petitioner's concession of the deficiency on the ground that the allowance of losses in the year claimed distorts petitioner's income pursuant to I.R.C. § 446(b), supports the imposition of section 6621(c) additional interest. Accordingly, we recommend that petitioner's concession should be accepted. When the petitioner has conceded multiple grounds for the deficiency, where some grounds give rise to section 6621(c) and other do not, the Tax Court has imposed section 6621(c). See Barber v. Commissioner, T.C. Memo. 1989-284. Further, if respondent is able to introduce evidence establishing that the transactions were straddles, section 6621(c) additional interest could also be imposed in the basis of section 6621(c)(3)(A)(iii). Therefore, we recommend that an answer to the amended petition be filed, which alleges that petitioner's concession of the deficiency on the ground that the allowance of losses in the year claimed distorts petitioner's income pursuant to I.R.C. § 446(b), is attributable to a tax motivated transaction under I.R.C. § 6621(c)(3)(A)(iv), and thus, supports the imposition of section 6621(c) additional interest. We further recommend that you allege that petitioner's

claimed losses disallowed pursuant to I.R.C. § 1091 involve straddle transactions as defined by I.R.C. § 1092(c), without regard to subsections (d) and (e) of section 1092, and thus, are attributable to a tax motivated transaction under I.R.C. § 6621(c)(3)(A)(iv).

Should you have any further questions regarding this matter, please contact Jeff Rosenberg at (FTS) 566-3233.

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By:



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